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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1951.

## No. 695

THE NORTHERN TRUST COMPANY OF CHICAGO AS EXECUTOR OF THE LAST WILL AND TESTAMENT OF ALETA M. GOMOLL, DECEASED,

*Petitioner,*

*vs.*

UNITED STATES OF AMERICA,

*Respondent.*

**PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

**and**

**BRIEF IN SUPPORT THEREOF.**

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

*To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:*

The Petitioner, the Northern Trust Company of Chicago as Executor of the Last Will and Testament of Aleta M. Gomoll, deceased, prays that a Writ of Certiorari issue to the United States Court of Appeals for the Seventh Circuit to review the decision of that Court reversing the decision of the United States District Court for the Northern District of Illinois, Eastern Division. The decision of the Circuit Court of Appeals was rendered on November 5, 1951 (R. 53), rehearing denied January 12, 1952 (R. 61). A transcript of the record of the case, including the proceedings in said Court of Appeals, is fur-

nished herewith in compliance with the rules of this Court.

## SUMMARY AND STATEMENT OF MATTERS INVOLVED.

All of the facts in this case were stipulated, and therefore the question presented is a true question of law. The following are the pertinent facts as they appear of record.

Prior to August 10, 1936 Edward Gomoll and Edith Rennert, as Administratrix of her deceased husband's estate, each owned one-half of the stock of the Standard Paste and Glue Company (R. 10). This suit is brought by the Petitioner as Executor of the Last Will and Testament of Aleta M. Gomoll, deceased. For convenience the Petitioner will be referred to as Edward Gomoll.

The total outstanding stock of the corporation was fifty shares and the par value of each share was $100 (R. 13).

Gomoll offered to buy Edith Rennert's stock at a price which she rejected as inadequate (R. 10).

Edith Rennert had her own auditors examine the corporate books and on the basis of their report, offered to sell her twenty-five shares of stock for $1000 per share or buy Gomoll's stock at that same price. She gave Gomoll his choice of buying or selling (R. 10).

Gomoll elected to buy at $1000 per share, which was exactly ten times the par value of each share, (R. 10) and on August 10, 1936 a written agreement (R. 13) was signed by the parties. By the terms of that agreement the purchase price of $25,000 was to be paid in installments over a period of 18 months, and the sale was to be completed through an escrow.

The agreement further provided that the seller would deposit the stock, endorsed in blank, with the escrowee, and that the buyer would deposit a note "to evidence and secure" the deferred installments of the purchase price (R. 14).

Paragraph 4. of the agreement provided in part, (R. 15):

> "the title to the said shares of stock owned by the first party and evidenced by Certificate No. 6 shall vest in second party only upon payment in full of the whole of the purchase price and interest thereon, as herein provided, etc."

Paragraph 5. of the agreement provided (R. 16):

> "All dividends paid on the capital stock of the Standard Paste and Glue Company, Inc., evidenced by Certificate No. 6, until the payment in full of the entire purchase price hereunder, shall be paid over to First Party on account of the next installment or installments either of principal or of interest of payments of the purchase price which may be due or may become due under the terms hereof, the payment of which dividends shall be endorsed upon the note deposited in escrow by the Second Party and reduce the obligation of the Second Party hereunder pro tanto."

On December 15, 1936, a dividend of $300 per share was declared and paid out of profits earned by the company before the agreement was made (R. 11). This Dividend was paid to the escrowee who paid it to the seller, and the entire dividend was retained by the seller (R. 11).

When the dividend was declared and paid the seller was the record owner of the stock on the corporate books and title to the stock was not transferred to the buyer until after the dividend had been declared and paid (R. 11).

The full stipulation of facts occurs in the record at pages 9-12.

This is a suit to recover income taxes paid under protest by Edward Gomoll and his wife on the dividend described above, which dividend was paid to and retained by Edith Rennert (R. 11). The District Court gave judgment in favor of the Plaintiff. The Circuit Court of Appeals reversed the judgment.

## OPINIONS BELOW.

The opinion of the Seventh Circuit Court of Appeals appears in the Record, pages 53-59. The opinion of the District Court appears in the Record, pages 37-44, and is reported at 100 F. Supp. 177.

## JURISDICTION.

The jurisdiction of this Court is invoked under title 28 U. S. C. Section 1254.

The judgment of the Court of Appeals for the Seventh Circuit, which Petitioner seeks to have reviewed, was entered on November 5th, 1951 (R. 53) rehearing was requested on Dec. 4th, 1951 (R. 60) and was denied on January 12th, 1952 (R. 61).

## QUESTIONS PRESENTED.

1. Does a partial forgiveness or cancellation of indebtedness create a taxable gain, when the indebtedness forgiven or cancelled represented the purchase price of property?

2. Where a debt represents the purchase price of property and it is reduced or cancelled, is it essential that there be a specific agreement to reduce the purchase price

of the property (as distinguished from the debt) in order that the reduction or cancellation may be classed as a "readjustment of the contract," and not a taxable gain?

3. What effect does "Beneficial Ownership" have on the taxability of a reduction of a debt which represented the purchase price of property?

## REASONS RELIED ON FOR ALLOWANCE OF WRIT.

### I.

The decision of the Circuit Court of Appeals which reversed the judgment rendered in the District Court is in conflict with a number of leading decisions of this Court. This is not merely a surface conflict, it is fundamental and irreconcilable. Some of the decisions of this Court which are contravened by the ruling of the Circuit Court of Appeals are:

*Lucas* v. *Earl,* 281 U. S. 111.
*Griffiths* v. *Commissioner,* 308 U. S. 355.
*Helvering* v. *Horst,* 311 U. S. 112.

It has long been recognized that income may not be assigned so as to escape the tax thereon. This point was squarely decided in *Lucas* v. *Earl,* 281 U. S. 111 and reaffirmed in the case of *Griffiths* v. *Commissioner,* 308 U. S. 355 in the following language which is found at page 358:

> "Taxes can not be escaped by 'anticipatory arrangements and contracts however skillfully devised * * * by which the fruits are attributed to a different tree from that on which they grew' *Lucas* v. *Earl,* 281 U. S. 111, 115."

The fundamental nature and the decisiveness of that ruling is epitomized in the case of *Saenger* v. *Commissioner of Internal Revenue* (5th Cir.) 69 F. 2nd 631 at page 632:

> "The rule of the *Earl* Case, while made graphic by a figure, is more than a figure of speech. It is an expression of the simple truth that earned incomes are taxed to and must be paid by those who earn

them, and unearned incomes to those who own the property or right that produced them, not to those to whom their earners or owners are under contract to pay them. It establishes once for all that no device or arrangement, be it ever so shrewdly or cunningly contrived, can make future incomes from property taxable to any but the owner of the right or title from which the income springs."

The decision in *Helvering* v. *Horst*, 311 U. S. 112 prevented a wealthy father, the owner of bonds, from escaping tax on the interest, even though he assigned to his son his right to receive that interest before it became due.

The decision of the Circuit Court of Appeals in the case at bar purports to point out a method by which the owner of corporate stock can by contract not only keep the title to the stock but also retain the dividends paid thereon and at the same time escape all liability for income tax on those dividends.

The decision of the Circuit Court of Appeals is of tremendous practical importance because of the fact that it opens a door long since believed to be irrevocably closed and establishes a new tax saving arrangement heretofore thought to be nonexistent.

Wealthy fathers and their tax counsel will not be slow to recognize the possibilities presented by this ruling if it is finally adjudged to be the law of the land.

## II.

The decision of the Circuit Court of Appeals in the case at bar is in direct conflict with decisions in a number of the circuits, including the Seventh Circuit, and a recent decision in the Tax Court of the United States. The following cases illustrate the conflict:

*Hirsch* v. *Commissioner,* 115 F. 2nd 656 (7th Cir.).

*Helvering* v. *A. L. Killian Co.,* 128 F. 2nd 433 (8th Cir.).

*Commissioner* v. *Sherman,* 135 F. 2nd 68 (6th Cir.).

*Gehring Publishing Co.* v. *Commissioner,* 1 T.C. 345.

Each of the above decisions involved a reduction or partial forgiveness of an indebtedness which represented the purchase price of property. The first three dealt with reductions of purchase money mortgages on real estate, and the fourth dealt with the reduction of a note which had been given as part of the purchase price of corporate stock. In each case the government contended that the forgiveness of indebtedness resulted in taxable income, and in each case the Court ruled to the contrary, indicating by various expressions that when the entire transactions were viewed as a whole, the reductions of indebtedness were *in substance* a lowering of the cost of the property purchased.

In *Hirsch* v. *Commissioner* (7th Cir.) 115 F. 2nd 656 at page 658, the Court said:

> "True, this was a forgiveness of indebtedness, but more than that, it was *in its essence* a reduction in purchase price etc." (emphasis added.)

In *Helvering* v. *A. L. Killian Co.,* (8th Cir.) 128 F. 2nd 433 at page 434, the Court said:

> "The transaction in question here was not a *mere cancellation* of indebtedness *but was a reduction of the purchase price of property etc.*" (emphasis added)

In *Commissioner* v. *Sherman* (6th Cir.) 135 F. 2nd 68 page 70, the Court said:

> "The *effect of the whole transaction* was a reduction of the purchase price of the property." (emphasis added)

In *Gehring Publishing Co.* v. *Commissioner,* 1 T.C. 345 at page 354, the Court in speaking of the *Hirsch* and *Killian* cases, said:

> "In line with these two cases we hold that the *net result* of the settlement in 1937 was *in substance* a reduction of the purchase price of the Hotel World Publishing Co., stock etc." (emphasis added).

The case at bar involves the reduction of a note given "to evidence and secure the installments of the purchase price payable etc." (R. 14)

The District Court said in its opinion (R. 39)

> "Since it appears from the stipulated facts that Edward Gomoll did not receive the proceeds of this dividend, the claim that Edward Gomoll is liable is necessarily bottomed on the principle of *forgiveness of indebtedness,* in other words, the dividend was used to pay his debt." (emphasis added)

Three of the four lower court cases quoted above were cited with apparent approval by this Court in the case of *Helvering* v. *American Dental Co.,* 318 U. S. 322, in the following language, found at page 327-8:

> "*Where the indebtedness represented the purchase price of property,* a partial forgiveness has been

> treated as a readjustment of the contract rather than a gain. *Hirsch* v. *Commissioner*, 115 F. 2nd 656; *Helvering* v. *A. L. Killian Co.*, 128 F. 2nd 433; *Gehring Publishing Co.* v. *Commissioner*, 1 T.C. 345." (emphasis added)

Unfortunately the language just quoted does not constitute a direct ruling by this Court on the point, since the Court was there deciding a case which involved a gift to a corporation and not a reduction of debt which represented the purchase price of property.

In a further and different sense the decision of the Circuit Court of Appeals is in conflict with the four lower Court cases cited under this point. The decision, it will be noted, is based upon the alleged "beneficial ownership" of the corporate stock by Edward Gomoll (R. 58):

> "The District Court thought that until *legal* title had passed, the purchaser was not entitled to the income from the stock, but, as we have seen, the beneficial interest in the stock and all accruements therefrom, were in the *beneficial owner*, the purchaser". (emphasis added)

This is clearly in conflict with the cases cited above. In each of those cases without exception, the tapxayer was the "beneficial owner" and also held the legal title to the property. Despite that fact, it was held in each case that there was no tax liability.

Since the decision of the Circuit Court of Appeals in the case at bar is in conflict with the cited cases from the various circuits, it would be highly desirable to have a direct ruling by this Court on this important phase of income tax law.

Wherefore, your Petitioner respectfully prays that the writ of certiorari be issued under the seal of this Court,

directed to the United States Court of Appeals for the Seventh Circuit, commanding that Court to certify and send to this Court on a day to be designated, a full and complete transcript of the record and of all proceedings in the United States Court of Appeals for the Seventh Circuit, had in this cause, to the end that this cause may be reviewed and determined by this Court; that the judgment of the United States Court of Appeals for the Seventh Circuit be reversed, and that Petitioner be granted such other and further relief as may be proper.

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UNITED STATES OF AMERICA,

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## BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

## FOREWORD.

The citation to opinions below, the statement of jurisdiction and summary statement of the cases are set forth in the attached Petition for Writ of Certiorari.

## ARGUMENT.

**A partial forgiveness or cancellation of indebtedness does not create a taxable gain if the indebtedness represented the purchase price of property.**

Although this point has never been directly decided by this Court, the principle was stated in the case of *Helvering* v. *American Dental Co.*, 318 U. S. 322. In that case this Court was passing upon a factual situation which involved a cancellation of indebtedness of a corporation, but that indebtedness did not represent the purchase price of property. It was there held that the cancellation of indebtedness was not a taxable gain because it was a gift. However, in reviewing the general field of cancellation of indebtedness this Court pointed out that the lower courts had ruled upon situations where the indebtedness cancelled or forgiven had represented the purchase price of the property and noted that under those circumstances the Courts had treated the cancellation as a readjustment of the contract rather than a gain. The following language from *Helvering* v. *American Dental Co.*, 318 U. S. 322 is found at page 327:

> "Possibly because it seems beyond the legislative purpose to enact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction. *Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain. Hirsch* v. *Commissioner*, 115 Fed. 2nd 656; *Helvering* v. *A. L. Killian Co.*, 128 Fed. 2nd 433; *Gehring Publishing Co.* v. *Commissioner*, 1 T.C. 345."

It should be noted in passing that the decisions of the lower courts cited in the above quotation are all consistent with the general principle laid down by this Court in *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170, namely, that substance rather than form is to be given controlling weight in determining what constitutes income. It seems rather obvious that the reduction of a note given as part of the purchase price of property is in substance, and in fact, a reduction of the cost of the property, and that is exactly what occurred in the case at bar.

**If a debt which represents the purchase price of property is forgiven, it amounts to a reduction of the cost of the property, regardless of the name by which it is called.**

There is no principle more firmly rooted in our laws than that laid down by this Court in *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170 at 174:

> "In determining what constitutes income, substance rather than form, is to be given controlling weight."

We submit that this principle is the basis of the rulings in *Hirsch* v. *Commissioner* (7th Cir.) 115 F. 2nd 656; *Helvering* v. *A. L. Killian Co.*, (8th Cir.) 128 F. 2nd 433; *Commissioner* v. *Sherman* (6th Cir.) 135 F. 2nd 68, and *Gehring Publishing Co.* v. *Commissioner*, 1 T. C. 345. In none of those cases does it appear that the parties agreed in so many words to reduce the *purchase price* of the real estate or the corporate stock there involved. What they reduced or cancelled was, in each case, a *debt*, represented by a note. Yet, in each case, the Court ruled that the "substance" of the entire deal was reduction of the purchase price, and decided the case exactly as though the parties had, in so many words, characterized the reduction of the *debt* as a reduction in the *purchase price* of the property.

This Court expressed a variation of the so-called "substance" rule in *Helvering* v. *The Safe Deposit Company of Baltimore,* 316 U. S. 56 at page 58:

> "In declining to pass upon this issue we do not reject the principle we have often recognized, that the *realities of the taxpayer's economic interest* rather than the niceties of the conveyancer's art should determine the power to tax." (emphasis added)

If it were possible to change the nature of a transaction by giving it a different name, the results, taxwise, would be incalculable. Courts have uniformly rejected form in favor of substance, because no other rule would be workable.

The realities of Edward Gomoll's economic interest in this case appear clearly. He gained nothing by the payment of the dividend. He contracted to buy corporate stock under an arrangement by which the price was not absolutely fixed, but was to be reduced if the value of the stock declined *before he acquired title to the stock.* In other words, if a dividend reduced the value of the stock, Gomoll would pay less because he received less. As the District Court said, (R. 39-40);

> "Since any diminution of the corporate assets would reduce the value of the stock a provision was made in the written agreement (par. 5, of Exhibit "A") that although dividends paid on the escrowed stock would go to the seller (as they must, since she retained the title to the stock) the buyer would receive credit on his notes given for the purchase price, for the full amount of the dividend."

Clearly, the substance of that arrangement was to reduce what Gomoll promised to pay for the stock, in order to balance a value permanently lost to him by the distribution of the dividend to Edith Rennert.

No matter what words are used to describe or characterize the arrangement, its essential nature remains unchanged. In essence it is a substitution of one value for another, and not a gain to Gomoll.

As was said in *Commissioner* v. *Pittsburgh & W. V. Ry. Co.* (3rd Cir.) 172 F. 2nd 1010, 1013,

> "The simple test to be applied in determining the existence of taxable income is whether there was simultaneously 'a decrease of liabilities with a corresponding increase of net assets' by reason of the purchase of one's outstanding obligation at a discount. *Helvering* v. *American Dental Co., Supra; Central Paper Co.* v. *Commissioner of Internal Revenue* (6th Cir.) 1946, 158 F. 2nd 131, 133".

It is apparent that the conclusion of the District Court on this point was correct:

> "Before the payment of the dividend Edward Gomoll was obliged to pay $1000 per share and he was entitled to receive stock that was backed by real assets worth $1000 per share. After the dividend was declared and paid Gomoll was obliged to pay only $700 per share, but the stock he received was worth only that amount." (R. 40.)

We submit that under these circumstances to say that the taxpayer gained by the payment of the dividend is a complete disregard of the substance of the entire transaction and the clearly expressed intention of the parties, and it violates every concept of "income" found in the statute and cases.

The position of the taxpayer in this case may be made clear by a simple analogy. He is in relatively the same position as the man who agrees to buy a safe at a price of $1000 providing the cash in the safe amounting to $500 is conveyed to him as a part of the deal. The agreement

further provides that if the cash is removed *before the safe is transferred to the buyer* the buyer is obligated to pay only $500 for the safe. From a standpoint of "economic realities" it is a matter of no consequence to the buyer which way the deal is consummated. If he pays only $500 he does not gain because he gets a safe worth only $500. If he pays the full $1000 he does not lose because he gets the safe worth $500 plus cash amounting to $500.

**The taxpayer in this case was not the "beneficial owner" of the corporate stock for income tax purposes, but even if he were, he would not be liable for a tax on the dividend in question.**

The term "beneficial ownership" has a variety of meanings depending upon the situation in which that term is employed. The use of the term in this case should be limited to a determination of the presence or absence of "gain". As the District Court said, (R. 42):

> "The existence or non-existence of a 'Benefit' to Gomoll is the gist of the entire case. It is apparent that Gomoll did not benefit by the declaration and payment of the dividend. A benefit (for tax purposes) is a profit or a gain, and Gomoll enjoyed no profit or gain by reason of the payment of the dividend. Therefore no tax should be assessed against him."

The Circuit Court of Appeals in this case reasoned that Gomoll, who had contracted to purchase the stock and take title at a future date, was the beneficial owner of the stock and that therefore he realized income by the payment of the dividend. The Court said (R. 58);

> "• • • it follows clearly, we think, that the purchaser, who was the beneficial owner of the stock, received the full benefit of the dividend; *that he alone was entitled to receive it, as the beneficial owner,*

> *and that he realized income in its receipt and disposition by application upon what he still owed for the stock''.* (emphasis added)

We believe that this line of reasoning is exactly the reverse of the proper approach. If it is desired to determine who is the "beneficial owner" of corporate stock, it is only necessary to ascertain who gains by the payment of dividends. Since the contract purchaser of the stock in this case was not one penny wealthier because of the payment of the dividend, he could not possibly have been the beneficial owner of the stock.

To hold otherwise would be, as this Court said in *Helvering* v. *Horst,* 311 U. S. 112;

> "to affront common understanding and to deny the facts of common experience".

Even assuming, for the sake of argument that the taxpayer in this case was the beneficial owner of the stock (which we deny) that fact would not operate to shift the burden of income tax from Edith Rennert, (who was the record owner of the stock and who received and retained the dividend), to Edward Gomoll.

The written contract between the parties provided (R. 16);

> "the payment of which dividends shall • • • reduce the obligation of (Gomoll) hereunder."

Thus the payment of the dividend to Edith Rennert was the event, the condition precedent, which reduced Gomoll's obligation to pay the full amount called for by the note.

In *Hirsch* v. *Commissioner* (7th Cir.) 115 F. 2nd 656; *Helvering* v. *A. L. Killian Co.* (8th Cir.) 128 F. 2nd 433; *Commissioner* v. *Sherman* (6th Cir.) 135 F. 2nd 68, and

*Gehring Publishing Co.* v. *Commissioner*, 1 T. C. 345, the taxpayers were the *beneficial owners* of the real estate and the corporate stock involved. In fact, they owned the legal title in each case, and yet they were held not to be liable for income tax when their notes were discharged for less than face value, *because those notes represented the purchase price of the property they had purchased.*

The reasoning of the various courts was that whatever may be said in case of the reduction of any other kind of debt, when that particular kind of debt is reduced (one which represented the purchase price of property) the net result or the substance of the transaction is a reduction of the cost of what was purchased.

In this case it is stipulated that Gomoll's note was given "to evidence and secure the installments of the purchase price" (R. 14). The reduction of that note was therefore "a readjustment of the contract rather than a gain", to use the language of this Court in *Helvering* v. *American Dental Co.*, 318 U. S. 322, at page 327 when it characterized the rulings of the lower courts in the cases it there cited.

## CONCLUSION.

The Circuit Court of Appeals for the Seventh Circuit, in reversing the decision of the District Court, has rendered an opinion in direct conflict wth one of the most basic concepts of income tax law, laid down in *Helvering* v. *Horst,* 341 U. S. 112, and by so doing, has invited wealthy taxpayers to escape taxes on income by following its decision.

The opinion of the Circuit Court of Appeals is also in direct conflict with the opinions of other circuits and the Tax Court of the United States, concerning the taxability of reduction of indebtedness representing the purchase price of property.

The Writ of Certiorari prayed for should be granted.

Respectfully submitted,

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